Merrill Lynch

THE TAX REFORM ACT OF 1986: FINANCIAL STRATEGIES FOR BUSINESSES

INTRODUCTION TO BUSINESS FINANCIAL STRATEGIES

The Tax Reform Act of 1986 represents a major restructuring of the Federal income tax system for both individual and corporate taxpayers.

The Business Financial Services Unit of Merrill Lynch, which serves the financial management needs of small and growing businesses nationwide, believes that careful planning and selected strategies can enable business owners to take maximum advantage of the positive aspects of the new law and minimize its potentially adverse provisions.

This brochure outlines key financial opportunities in the areas of working capital management, equipment finance, tax and investment strategies, retirement planning and business insurance. *We recommend that business owners carefully review the specific effects of the new law on their businesses, as well as their personal finances, with their tax advisors and in conjunction with Merrill Lynch Financial Consultants. For information about Merrill Lynch companion publications on the new tax law and individual investors, refer to the last page of this brochure.*

WORKING CAPITAL MANAGEMENT

New Corporate Tax Rates

Effective for taxable years on or after July 1, 1987, the new tax law will provide a three-bracket *graduated* corporate tax rate structure as follows:

Taxable Income	Rate
$50,000 or less	15%
$50,000-$75,000	25%
$75,000–$100,000	34%

Corporations having taxable income over $335,000 will pay tax at a *flat* rate of 34%. Corporations with taxable income between $100,000 and $335,000 will be subject to a 5% surcharge, which effectively phases out the benefit of the lower bracket taxation and introduces a marginal 39% tax bracket for such taxable income.

For taxpaying corporations, a "blended" corporate tax rate will be in effect for 1987. For calendar year corporations, the maximum "blended" rate will be 40% in 1987. Corporations whose taxable year begins before July 1, 1987 will also be subject to a "blended" rate. Such rate will reflect current tax rates for the portion of the tax year prior to July 1, 1987, and the new rates for the balance of the year.

Investment Earnings on Cash Reserves

As a result of the lower corporate rate structure, investment earnings on corporate cash reserves will become more meaningful. The after-tax yields on Treasury Bills and Certificates of Deposit will rise. Cash basis corporate taxpayers may begin to take immediate advantage of next year's lower rates by shifting out of vehicles that will pay income in 1986, such as money market funds, and into short-term discount obligations, such as Treasury Bills and Certificates of Deposit, which do not produce income in 1986 but, instead, pay interest in 1987 when corporate rates are lower.

Unincorporated Businesses

Owners of unincorporated businesses, including partnerships and sole proprietorships, as well as S corporations, may benefit from tax cuts resulting from the lowering of individual tax rates to a maximum of 28% in 1988. With individual rates below top corporate rates, unincorporated businesses may benefit even more from the new tax rate structure.

For 1987, a maximum "blended" individual tax rate of 38½% will be in effect for these unincorporated entities. As with corporate taxpayers, investment of excess cash by utilizing the same strategies recommended for corporations should translate into better bottom-line returns.

Interest Expense

Corporations and unincorporated businesses that borrow can continue to deduct 100% of their interest expense as it relates to their business needs. Thus, interest expense incurred by using a line of credit remains fully deductible by a business. This contrasts sharply with the restrictions on deductibility of interest on loans by individual consumers.

The fundamental changes in the income tax rates for corporations should affect the working capital management practices of corporations. Businesses have the potential of enjoying better bottom-line returns on their cash reserves while still being able to deduct their interest expense on their lines of credit. For that reason, the advantages of a central assets account, such as the Merrill Lynch Working Capital Management™ Account (WCMA® account), are enhanced. The WCMA account automatically combines a business's checking account with an investment account, and for those who qualify, either a margin based or general line of credit. Thus, businesses can take maximum advantage of both the earning power of their cash reserves and fully tax-deductible interest resulting from using their line of credit.

For more complete information on the Merrill Lynch Working Capital Management Account, including all charges and expenses, send for a prospectus from your nearest Merrill Lynch office. Read the prospectus carefully before investing or sending money.

Recommended Strategies

- **Keep corporate cash reserves fully invested for better bottom-line returns.**
- **Cash basis corporate taxpayers should defer reportable income into 1987 by shifting funds from instruments which produce income in 1986 to obligations paying interest in 1987.**
- **Use 100% interest expense deduction to help finance your business's growth.**

EQUIPMENT FINANCE

Two provisions of the new law will have a major impact on equipment purchases—the repeal of the investment tax credit (ITC) retroactive to January 1, 1986 and reduction of ITC carry forwards, and changes in depreciation schedules.

Accelerated cost recovery system (ACRS) depreciation is revised into a six-class system for personal property which, depending upon the type of property, ranges from 3 to 20 years. The cost recovery for real property is extended from the current 19-year period to 27½ years for residential real property and 31½ years for commercial property. Thus, businesses planning acquisitions of property should accelerate to 1986 purchases of certain property which will have more favorable depreciation treatment under current law than under the new law.

In addition, the amount of personal property that may be expensed by a business will be increased in 1987 to $10,000 from $5,000. For companies, however, who invest in excess of $200,000 in equipment, the $10,000 special deduction is phased out.

Debt Financing Versus Leasing

Depending on a business's tax rate and the equipment, the changes in ITC and depreciation, coupled with the retention of deductibility of interest expenses for businesses, suggest that, in the future, debt financing for the purchase of equipment may be more attractive than leasing. Non tax-oriented leasing, which is not predicated upon the ITC, may continue to be attractive for many businesses and types of equipment because it can provide 100% financing and free the business owner of the task of carrying or selling obsolete equipment. Merrill Lynch offers qualified businesses both non tax-oriented equipment leasing and flexible term debt financing for equipment.

Recommended Strategies

- **Consider using debt financing or non-tax-oriented equipment leasing to finance your future business equipment acquisitions.**
- **Accelerate to 1986 planned purchases of certain property which will have more favorable depreciation treatment under current law than under the new law.**

Approved For Release 2011/01/10 : CIA-RDP89-00066R000400070002-2

TAX AND INVESTMENT STRATEGIES

Capital Gains

The alternative tax rate for net capital gains of corporations is repealed when the new corporate rates become fully effective. During the transition period in 1987, the capital gains rate for corporations will be increased from 28% to 34%. As a result of the higher capital gain rate for 1987, it would be advantageous, where appropriate, for corporations to take long-term gains on investment assets in 1986 at the lower rate. Among the holdings with capital gains that should be reviewed by corporations for possible sale this year are municipal and corporate bonds subject to call, Certificates of Deposit, zero coupon bonds and Treasury Investment Growth Receipts™ with low yields to maturity as well as common and preferred stocks.

Similarly, owners of partnerships, proprietorships and S corporations should consider taking long-term investment gains in 1986 at 20%, the maximum capital gains rate for individuals, instead of the maximum 1987 rate of 28%.

Municipal Bonds

Despite lower tax rates, corporations may be able to earn higher after-tax returns from tax-exempt issues such as municipal bonds, which have been trading at very attractive yields relative to taxable instruments. It should be noted, however, that interest earned on certain private purpose bonds issued after August 7, 1986 will no longer be exempt from Federal income tax. Furthermore, interest earned on private purpose bonds that retain the tax exemption after August 7, 1986, will become a tax preference item in 1987 and subject to the 20% corporate alternative minimum tax (AMT).

The corporate AMT is designed to prevent profitable corporations from avoiding significant current tax liability. For the most part, this is accomplished by treating one-half of untaxed reported profits as a tax preference item. The starting point for calculation of untaxed reported profits is net income as disclosed on the corporation's financial statements. This amount, referred to as "book net income," would include amounts exempt from Federal tax such as tax-exempt municipal bond interest and the dividends-received deduction. One-half of the excess of adjusted book income over AMT income is treated as a tax preference item.

Using the Dividends-Received Deduction

Many corporations, including professional corporations, with excess cash reserves, take advantage of federal tax law exemptions for corporations and earn tax-favored income by purchasing common and preferred stocks with investable capital. Under old law, such corporations were permitted to exclude from their taxable income 85% of dividend income received from certain other corporations whose stock they held. This made the after-tax yield on these investments more attractive than yields on fully taxed instruments. For example, the retention of dividend income earned on these investments was 93.1% for a corporation in the 46% tax bracket because only 15% of the income was taxed at the corporation's rate (15% × 46% tax rate = 6.9%; 100% − 6.9% = 93.1%).

Under the new law, the dividends-received deduction drops to 80%. But, with the maximum corporate tax bracket lowered to 34% in 1988, the retention of dividend income from these issues increases to 93.2% (20% × 34% tax rate = 6.8%; 100% − 6.8% = 93.2%).

For 1987, with the maximum corporate tax rate at the 40% "blended" rate, the retention of dividend income will be 92% (20% × 40% tax rate = 8%; 100% − 8% = 92%). It should be noted, also, that the untaxed portion of the dividend income received by a corporation may be subject to the corporate alternative minimum tax.

Nevertheless, common and preferred issues should continue to provide corporations with attractive after-tax returns. For corporations seeking to take advantage of the 80% dividends-received deduction, Merrill Lynch offers the Merrill Lynch Corporate Dividend Fund, a mutual fund especially designed for this purpose.

For more complete information on the Merrill Lynch Corporate Dividend Fund, including all charges and expenses, send for a prospectus from your nearest Merrill Lynch office. Read the prospectus carefully before you invest or send money.

New Life Insurance Programs

The new tax law continues to permit earnings within a life insurance contract to grow tax-free. In addition, businesses remain able to access principal and earnings from such contracts in the form of tax-free policy loans. Further, such programs can provide income-tax-free death benefits to the business. As a result, insurance programs, such as single premium life insurance (Prime Plan® and the ML-ONE™ plan), remain a highly attractive tax and financial strategy for businesses. It is also noteworthy that the benefits ancillary to the death benefit offer significant advantages including possible insulation from penalty taxes of up to 38½% on excess corporate accumulated earnings (IRS Section 531) when such programs are used in support of a valid business purpose, such as deferred compensation arrangements, buy-sell agreements and key-employee insurance.

For more complete information on Prime Plan or ML- ONE, including all charges and expenses, send for a prospectus from your nearest Merrill Lynch office. Read the prospectus carefully before you invest or send money.

Recommended Strategies

- **Where appropriate, realize long-term gains on investments in 1986.**
- **Consider tax-exempt municipal bonds when yields compare favorably with taxable instruments.**
- **Utilize the 80% dividends-received deduction on corporate investments.**
- **Capitalize on highly attractive tax-free yields available in new life insurance programs.**

RETIREMENT PLANNING

The new law signals significant changes in retirement plans and places restrictions on Individual Retirement Accounts for individuals covered by an employer sponsored tax-qualified retirement plan, such as a pension plan, profit-sharing plan, 401(k) program, 403(b) plan, Simplified Employee Pension (SEP) plan or a stock bonus plan.

Qualified Plans

Contribution and benefit limits will be left largely intact on tax-qualified defined contribution plans such as money purchase pension plans and profit-sharing programs. Thus, employers will continue to be able to secure significant tax deductions from such programs while enabling plan participants to tax-defer personal income today and build substantial capital for distribution at retirement. Defined benefit pension plans with a normal retirement age of less than 65 will now provide lower maximum benefits to participants with a commensurate reduction in tax-deductible contributions by the employer. Both types of plans will be impacted by changes in rules governing integration of such plans with Social Security, resulting in generally greater contributions and benefits for lower paid plan participants.

The new law also impacts employers with more than one plan by further restricting the combined plan deduction limit for such employers to 25% of compensation. In addition, the carry forward applicable to profit-sharing plans will be repealed, which means that "catch-up" contributions to such plans must be made in 1986.

IRAs and Qualified Plans

In 1987 and thereafter, tax deductions for IRA contributions can be claimed only by those who are not covered by another retirement plan or for married couples who have joint adjusted gross income under $40,000 ($25,000 for single returns). If joint adjusted gross income is between $40,000 and $50,000 ($25,000 and $35,000 for single returns), deductions for IRA contributions are permitted on a pro rata basis. Other individuals can make non-deductible contributions to an IRA within the present law limitations of $2,000 for individuals and $2,250 for combined individual and spousal IRAs. All earnings and gains on contributions to an IRA will be tax-deferred until withdrawn, regardless of whether the contribution is deductible.

Vesting of Benefits

Vesting of benefits for participants in qualified retirement plans has been accelerated for plan years beginning after December 31, 1988. For other than top-heavy plans, for which there are separate vesting requirements, an employer-provided benefit must vest at least as rapidly as under one of the following two alternative minimum vesting schedules:

- 100% of the participant's accrued benefit vested upon the participant's completion of five years of service;
- a "step" vesting schedule of 20% of the participant's accrued benefit after three years of service, 40% after four years, 60% after five years, 80% after 6 years and 100% upon completion of seven years of service.

In addition, a retirement plan may not condition eligibility to participate in the plan on more than two years of service, and a plan which has a two-year service eligibility requirement must provide full and immediate vesting after two years.

Interest on Loans

Key employees will no longer be permitted to deduct from taxable income interest on loans from any qualified retirement plan. Deduction of interest on loans will no longer be afforded to any employee whose loan is secured by an elective deferral from a 401(k) plan or tax-sheltered annuity [Section 403(b) plan.]

Retirement Plan Distributions

Distributions to participants under a qualified retirement plan must commence no later than April 1 of the calendar year following the year in which the participant attains age 70½, without regard to the actual date of retirement. This provision applies to distributions made after December 31, 1988.

Effective January 1, 1987, ten-year forward averaging treatment on lump-sum distributions to participants from a qualified retirement plan is generally replaced by five-year forward averaging for lump-sum distributions received after age 59½.

Under a transition rule, a participant who had attained age 50 by January 1, 1986 will be permitted to make an election of five or ten-year forward averaging with respect to a single lump sum distribution without regard to the attainment of age 59½. All individuals, regardless of age, will continue to be allowed to roll over any lump sum retirement distributions into an IRA instead of using five or ten-year averaging.

Plan administrators and participants may want to consider a "qualified annuity" in lieu of a lump-sum distribution or IRA rollover. In addition to providing a guaranteed lifetime income, a qualified annuity may avoid the normal annuity withdrawal penalties before age 59½.

401(k) Plans

Of interest to businesses that have adopted or are considering a 401(k) plan is the fact that, effective for taxable years beginning after December 31, 1986, maximum annual elective deferrals by an eligible employee would be limited to $7,000. The special non-discrimination tests applicable to 401(k) plans would be modified and would apply to all employer matching contributions as well as after-tax employee contributions. It should be noted that, as a result of lower individual tax brackets, employers may find it necessary to make larger matching contributions to attract employees to participate in a tax-advantaged 401(k) program.

Qualified cash or deferred 401(k) arrangements are not available to employees of state or local governments, unless the plan was adopted before May 6, 1986, or to employees of tax-exempt organizations, unless the plan was adopted before July 1, 1986.

Simplified Employee Pension Plans

Employers with no more than 25 employees can permit employees to defer up to $7,000 annually through a Simplified Employee Pension Plan (SEP) provided at least 50 percent of the employees elect to have amounts contributed to the SEP. These elective SEP contributions would operate much like 401(k) plans and are expected to be popular among smaller employers.

In light of the legislative changes to qualified retirement plans, employers should arrange with their Financial Consultant to have their existing plans professionally reviewed by a Merrill Lynch Pension Consultant.

Deferred Compensation Plans

Non-qualified deferred compensation programs, also known as salary continuation plans or executive deferral plans, should increase in popularity. Though such programs do not provide corporations with immediate tax deductions, deferred compensation arrangements afford corporations the right to select their participants and benefits, making them especially attractive to employers. Programs allowing highly compensated employees to defer income over the next two years, as individual tax rates decline, should have particular appeal.

Recommended Strategies

- **Maximize your retirement plan contributions for 1986 including possible "catch-up" contributions to optimize tax deductions for your business and tax-deferred earnings for participants.**
- **Have your existing retirement plan professionally reviewed to assure that it will meet your objectives for 1987 and beyond.**
- **Consider the attractions of simplified employee pension plans and non-qualified deferred compensation arrangements.**

BUSINESS INSURANCE

Buy and Sell Agreements

Most significantly, with individual tax rates below top corporate rates under the new law, "cross purchase" buy and sell agreements, wherein the individual owners are the buyers and sellers respectively, may hold significant tax advantages over more traditional buy and sell arrangements structured as corporate stock redemptions. Such individual owner "cross purchase" agreements may be optimally funded with corporate dollars via split-dollar life insurance (i.e., the corporation assists in the premium payments) or through a bonus life insurance plan. Such strategies would allow for the leveraging of more favorable individual tax brackets, the minimization of the alternative minimum tax issue, and the attainment of additional tax benefits to the owners in the form of reduced income taxes on the subsequent sale of their respective business interests.

Estate Tax Insurance

All business owners should assess the Federal Estate Tax liability their business may create for their estate. Specifically designed life insurance, known as "estate" or "survivorship" insurance, provides the least expensive and most systematic method to meet this obligation. Corporate business owners should consider enlisting the aid of their companies, not only in funding the premiums through "split-dollar" or "bonus" arrangements, but also in establishing fair values for buy and sell agreements, which will be the basis of the future estate tax liability.

Insurance and Tax Reform

Among the other provisions of the new law that affect life insurance and annuities are:

- A cap on the interest deduction on policy loans in business-owned insurance on the life of an employee. The interest deduction taken by the business is limited to $50,000 of loans per employee on policies purchased after June 20, 1986.

- The elimination of the tax deferral on earnings from annuity contracts held by non-natural persons, such as corporations, for annuities purchased after February 28, 1986.

- The possible inclusion of a portion of the cash values and death benefits in business-owned key employee insurance in the computation to determine if a corporation is subject to a corporate alternative minimum tax.

Business owners are advised to review their present business insurance coverage and their future needs in consultation with their tax advisors and Merrill Lynch Insurance Specialists available through Merrill Lynch Financial Consultants.

Recommended Strategies

- **Use insurance to protect against the loss of a key employee while benefiting from its superior tax advantages.**

- **Consider employing individual owner "cross purchase" buy and sell agreements for corporate and personal tax advantages.**

- **If needed, purchase "estate tax insurance" with company assistance.**

IN CONCLUSION

This brochure gives you the highlights of the Tax Reform Act of 1986 as it affects businesses and suggests strategies for taking advantage of its benefits and minimizing its adverse effects. It is a general guide, and you should consider any of the recommendations with your own tax advisor and in light of your company's particular situation.

We urge you to begin your planning now so that you can take fullest advantage of the opportunities the act creates. Your Merrill Lynch Financial Consultant will be happy to provide you with the additional information and assistance that you might need to make effective tax planning decisions.

Tax Reform and Your Personal Finances

For individual investors, Merrill Lynch has prepared two other publications on the new tax law. Our brochure entitled Crucial Questions About Tax Reform and Your Personal Finances *provides an overview of several major changes in the law as well as a profile form to help you review your finances and plans for the future with your Financial Consultant.*

Our publication entitled An Investor's Guide to the 1986 Tax Reform Act *provides a comprehensive analysis of the new tax law and a discussion of its broad implications. To obtain copies of these brochures, ask your Merrill Lynch Financial Consultant.*

Approved For Release 2011/01/10 : CIA-RDP89-00066R000400070002-2

Treasury Investment Growth Receipts
is a service mark of Merrill Lynch & Co., Inc.

Prime Plan is a registered service
mark of Monarch Life Insurance Co.

ML-ONE is a service mark of
Family Life Insurance Co.

Working Capital Management and
WCMA are service marks of Merrill
Lynch & Co., Inc.

Code # 10443

Approved For Release 2011/01/10 : CIA-RDP89-00066R000400070002-2